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C O N F I D E N T I A L SECTION 01 OF 03 ISLAMABAD 001900

SIPDIS

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TAGS: ECON EFIN EINV PGOV PREL PK
SUBJECT: INITIAL ECONOMIC POLICY DIRECTION LOOKS GOOD

Classified by: DCM Peter Bodde for reasons 1.4 (b) and (d)

Summary

¶1. (U) Prior to his resignation as Finance Minister, Ishaq Dar set out broad priorities for Pakistan's FY 2008-2009 budget during a May 12 speech at a pre-budget seminar at the Federation of Pakistan Chambers of Commerce. Dar pledged to focus on "fiscal consolidation" and to raise the tax-to-GDP ratio, which currently is only 10.5 percent of GDP. He also pledged to continue liberalization, deregulation and privatization policies. Dar touched on Pakistan's large fiscal and current account deficits, soaring inflation, and low tax-to-GDP ratio as concerns for the present government. He also threatened to impose penalties on currency speculators.

¶2. (C) In a meeting with the Special Secretary of Finance Dr. Ashfaque Hassan Khan on May 14, Khan commented that very little work on the budget had been done, and that he hopes that Dar's speech, which he wrote, will actually set the policy direction. In response to Econoff's question, Khan confirmed that the GOP is expecting USD 3 billion in foreign exchange inflows before the July 30 end of the current fiscal year. He hoped that these inflows would keep foreign exchange reserves at the USD 12 billion level and keep the rupee from depreciating further. End summary.

"Fiscal consolidation" main priority for new budget

¶2. (C) Then Minister for Finance, Revenues and Economic Affairs, Ishaq Dar set out the broad policy directions for Pakistan's 2008-2009 budget at a May 12 pre-budget seminar organized by the Federal Board of Revenue in collaboration with the Federation of Pakistan Chambers of Commerce and Industry. Economic Officers subsequently met with Special Secretary of Finance, Dr. Ashfaque Hassan Khan (please protect) on recent macroeconomic developments.

¶3. (SBU) Dar told that Chamber of Commerce audience that Pakistan's 2008-2009 budget will focus on "fiscal consolidation." Pakistan's tax-to-GDP ratio at 10.5 percent of GDP is not only low, but has declined. "The only country, perhaps, worse than Pakistan in our region is Afghanistan," Dar observed. Pakistan will have to allocate more resources for strengthening the country's physical and human infrastructure to sustain economic growth.

¶4. (SBU) "The challenge for us will be to significantly enhance Pakistan's tax-to-GDP ratio in order to generate enough resources to finance development activities." The government, he said, will try to

broaden the tax base and to include untaxed and under taxed sectors. (Note: Pakistan's agriculture sector is not taxed; services -- which comprise over 50 percent of GDP -- are undertaxed; remittances are not taxed; there are no capital gains and only minimal real estate taxes. End note.) "Broadening the tax base will also ensure fair distribution of the tax burden among various sectors of the economy," Dar remarked.

Liberalization policies to continue

¶5. (U) Dar highlighted that additional power generation and energy conservation, economic liberalization, deregulation, and a transparent privatization process will be at the core of the government's economic reform agenda. He added that making the State Bank of Pakistan and the Securities and Exchange Commission autonomous, and promotion of foreign direct investment will also be priorities. The government will also focus on development of the agriculture and manufacturing sectors. Dar assured his private sector audience that the government will continue to promote private sector development because "the private sector is the real engine of growth and the main source of employment generation. We also believe that the private sector can produce, distribute and trade goods and services more efficiently."

¶6. (U) Dar further recommended that tight monetary policy be maintained to contain aggregate demand. Highlighting the government's medium-term agenda of economic reform and development, he said that the government intends to keep the growth rate in the range of 6 to 7 percent over the next 5 years. However, he said "we believe that the growth of this magnitude will not be forthcoming automatically. More reforms are needed to sustain a growth rate at

this level."

Poverty alleviation package?

¶7. (C) The Minister remarked that the combination of food shortages and record food inflation require attention. "We are putting together a targeted package of measures to help the poor and vulnerable segments of the society." Dar urged the businessmen and the well-to-do to pay their taxes to help the government provide relief to the poor. Econoffs asked Khan how the GOP plans to finance a poverty alleviation package. Khan said that, given the current budgetary shortfalls, it would be difficult to fund programs that could make a difference, particularly since the poorest Pakistanis are in rural areas.

GOP Expecting Foreign Inflows

¶8. (C) Econoffs asked Khan to confirm Dar's comment that the GOP will see over USD 3 billion in foreign exchange inflows before the June 30 end of the fiscal year. The USD 3 billion inflows include USD680 million from the sale of 15 percent of Muslim Commercial Bank to Maybank of Malaysia, USD 100 million brought in by Barclays Bank to meet capital adequacy requirements, USD 60 million due to Toyota Company's Indus Motors share purchase, and USD 1.2 billion in current account support from the Asian Development Bank.

Dar Warns the Speculators

¶9. (U) Dar warned speculators not to manipulate the exchange rate. "These speculators should not forget the similar episode of 1998-99 when the government brought exchange rate down to Rs.50 per dollar from Rs.64 per dollar in a short span of time," he remarked. "They should stay away from these anti-state activities; otherwise, the government will take stern actions against these unscrupulous elements." Dar highlighted that the State Bank of Pakistan is watching the market players very closely.

Political expediency blamed for current economic woes
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¶10. (U) Repeating one of his themes, Dar commented that "over a year of total inaction and political expediency of the previous government about addressing domestic and external challenges further accentuated macroeconomic imbalances." As a result, the economy of Pakistan is currently under pressure and facing four major challenges: slowdown in economic growth; rising inflation, particularly food inflation; a growing fiscal deficit and widening trade and current account deficits. Dar added that the growth target for the current fiscal year has been revised downward from 7.2 percent to 6.0 percent, rather than the 7 percent target. "Poor performance of the agricultural sector, and weaker-than-expected growth in manufacturing and services sectors are the key drivers for scaling down the growth target," he observed.

Inflation to Stay Above 10 Percent

¶11. (U) The Finance Minister said that inflation in general and food inflation in particular have emerged as a major source of concern for policy-makers. Higher food prices, expansionary fiscal policy, extra-ordinary increase in government borrowing from the State Bank of Pakistan (SBP), energy price increases, and unanticipated increase in international commodity prices are responsible for Pakistan's record inflation. "The year is most likely to end with an average inflation of over 10 percent against the target of 6.5 percent," he maintained. Dar added that the government's heavy reliance on borrowing from the SBP caused excessive monetary expansion, which has become one of the principal sources of inflation.

¶12. (U) Dar pointed out that the fiscal deficit for the current year was targeted at 4.0 percent of GDP. Recent data indicate that during the first nine months (July-March) of the current fiscal year, the fiscal deficit stood at 5 percent of GDP. Dar remarked that, "had there been no measures undertaken by the government, the annual budget deficit would have reached 9.5 percent of GDP." He attributed the large fiscal deficit to weaker-than-expected tax collection due to slower-than-targeted real GDP growth and adverse law and order

situation; increases in the prices of oil and food; subsidized power tariffs; and mismanagement of wheat exports based on inaccurate estimates and subsequent import of wheat at much higher prices.

Oil Import Bill Drives Trade Deficit

¶13. (U) As a result of higher oil prices, Pakistan's oil import bill reached USD 7.9 billion in the first nine months (July-March) of the current fiscal year. (Note: This was the target for the entire fiscal year. End note.) The oil bill is expected to reach USD 11.3 billion by the end of the fiscal year - almost 42 percent more than the targeted level. As a result of the increase in the oil import bill and excessive imports of luxury goods, Pakistan's trade deficit has surged to USD 10.8 billion in the first nine months (July-March) and the year is likely to end at USD 13.8 billion - a deterioration of almost 46 percent over last year. The current account deficit has widened to USD 9.86 billion in the first nine months (July-March) of the current fiscal year. The target for the entire fiscal year was USD 7.95 billion.

Comment

¶14. (C) The present government plans to continue with the liberalization, deregulation and privatization policies, and has promised to give the lead role to the private sector in economic development, which bodes well for the long-term economy. However, Khan and others in the Finance Ministry complained that there is currently no policy direction in the Ministry, and budget preparation is woefully behind. Normally the Ministry of Finance presents its budget for the following fiscal year during the first or second week of June. Parliament then debates the budget, and it is passed before the June 30 end of the fiscal year. However, this year's budget preparations are behind schedule.

¶15. (C) Khan was particularly bitter about the hold put on the exchangeable bond issuance, particularly after the issuance had been given significant international publicity. He believed the lack of policy direction has damaged Pakistan's creditability, and the reversal of the bond issuance approval indicates the present government's tendency to reverse decisions and policies after announcing them. Moody's downgrading of Pakistan's credit rating last week bears out Khan's view. He remarked that five percent economic growth for the current fiscal year would be an achievement, since political instability is making it difficult for the government to address serious policy issues. End comment.

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